Questions to the Staff Task Force to consider:

(a) Where do you draw the line between Subprime lending and predatory lending?

	Subprime Lending	**Predatory Lending**
Rates	*Above* prime rates to cover the increased risk and transaction costs of lending to borrowers: • with poor or bad credit records • with insufficient credit history (young couples) • with nontraditional credit sources (self-employed) • who are unemployed but need to capture equity in their home to ride out tough times (victims of the dot-com bust) • who pose greater credit risk based on their FICO scores	*Substantially above* the prime rates *and* associated with large fees and points added to the principal and financed as part of the loan. A loan for which the cost to the borrower exceeds the rate dictated by the lender's risk.
Underwriting Determinants	Loans based on borrowers' income stream and ability to repay the loan.	Loans based on equity without regard to the borrowers' ability to pay.
Costs and Risks	Costs correctly reflect the risk associated with extending the loan.	Costs far exceed the associated credit risk.
Borrower Profile	Teachers, peace officers, fire fighters, or those with credit disadvantages which bar them from being able to qualify for prime rate loans.	People who, due to lack of educational resources, do not or will not seek assistance. Typically senior citizens, immigrant populations, and minority groups. Individuals who seek out lenders who are known not to follow state and national rules, in order to get cash on hand immediately.
Accompaniments	Often used in conjunction with homebuyer assistance programs given the high housing costs in San Jose and the Bay Area.	Often accompanied by fraud, such as falsifying of borrowers' income on loan documents, forging the borrower's signature, and diverting funds away from the lender or the borrower.

Practices	Follows State and National rules and regulations on lending, including credit counseling.	**Does Not** and never will follow State and National rules and regs on lending. Typically do not have credit counseling.

No comprehensive data are available on the incidence of these practices, though it is widely accepted that predatory lending activity is concentrated within the subprime market.

According to a U.S. Department of Housing and Urban Development report, “subprime lending serves a critical role in the nation’s economy by providing loans to borrowers who do not meet the credit standards for borrowers in the prime market.” The associated higher interest rates of subprime loans when compared to prime loans exist to offset the greater risks taken by the lenders in issuing those loans.

In fact, it is the lending ***practices***, such as falsifying documents and signatures or intentionally misinforming borrowers about the terms of a loan – and not necessarily the actual loan provisions – that result in predatory lending. There is no uniformly accepted definition for what constitutes predatory lending according to the U.S. Government Accounting Office (GAO).

There are, however, uniformly accepted practices that result in predatory loans. As noted in the previous chart, predatory lending rates are usually substantially above the prime rate and large fees and points are typically charged, added to the principal, and financed as part of the loan. The total cost of the credit often exceeds the credit risk; however, sometimes the credit risk is so high that the loan seems to have been made with the expectation of borrower default. In a refinance, as the loans are originated based on the equity in the home, the predatory lending practice occurs without regard to the borrower’s ability to pay.

Many times the initial loan terms disclosed to the borrower are substantially different in the contract. Frequently, the borrower has little time to review the documents and is pressured to sign quickly without asking questions. This scenario does not take in account those cases of borrower fraud.

Fraud may be present in a number of ways, and can be prosecuted. Practices include falsifying borrower income on loan documents, forging the borrower’s signature, and diverting funds away from the borrower.

(b) Are there existing problems in San Jose due to illegal activity? If so, what is the District Attorney doing about it?

With an estimated population of nearly 900,000[1], San Jose *may* have cases of abusive lending practices. The basic law of averages would apply when comparing cities such as San Jose with, for example, Campbell. However, anecdotal evidence does not prove that there is an inordinate

[1] The estimated population for San Jose as of 2002 according to the American Community Survey Profile of the U.S. Census Bureau is 896,143. The American Community Survey is a new nationwide survey designed to provide communities a fresh look at how they are changing. It is a critical element in the Census Bureau's reengineered 2010 census plan. ***Note:*** The 2002 American Community Survey universe is limited to the household population and excludes the population living in institutions, college dormitories, and other group quarters.

problem with predatory lending in San Jose. Quantifiable statistical evidence paints a more objective picture. The statistics and accompanying analysis provided by AFSA and Real Estate Solutions show that while there is a significant subprime lending market active in San Jose (based primarily on higher median incomes and home prices), there is no hard statistical evidence to support the need for a local ordinance.

Consumers, armed with the knowledge of how to identify, avoid or report abusive lending practices are a far more powerful approach than any single statute. There are successful program templates operating today that would expedite the citizen outreach and education programs. We need to bridge the gap between available resources and consumer knowledge.

While the relationship between subprime lending and predatory lending is given the most scrutiny and attention, a greater correlation exists between predatory lending and fraud. The first question when determining whether or not a loan is in fact predatory should not be whether or not a loan is subprime, but rather a better indicator is whether or not fraudulent practices have occurred.

As to what the District Attorney's Office is doing about the issue, in a presentation to the Predatory Lending Working Group on November 3, 2003, representatives from the DA's office discussed the operations of both their FAST (Financial Abuse Strike Team) and Real Estate Units. This involvement has included prosecution for all facets of loan problems including instances of kickbacks, loan fraud, falsifying documentation, and borrower fraud.

Interestingly, it was noted the FAST program hasn't issued any predatory lending cases (at the time of the presentation, they were handling 74 active cases). Most or all such cases were prosecution for theft by larceny or theft by false pretenses, and of that caseload, 75% were perpetrated by friends or relatives.

Under Section 27388 of the Government Code, "a fee of up to $2 shall be paid at the time of recording of every real estate instrument." This is to support the Real Estate Fraud Prosecution Trust Fund, which finances the DA's Real Estate Unit. It was stated they were seeing more activity from out of state transactions and that the majority of their prosecutions were based on unfair business practices (already covered under Section 17200 of the Business Code) and false advertising (already covered under Section 17500). They did not provide a caseload number.

In a letter dated August 29, 2003, responding to our inquiries regarding assertions made at the April 10 meeting of the city's Housing Advisory Commission that the County supported a local ordinance, District Attorney George W. Kennedy stated, "I have not taken a position on the proposed San Jose Ordinance you reference. My office does not support it."

In addition, the Fair Mortgage Terms Initiative (FMTI) made a presentation to the Working Group on March 12, 2004. They stated they are working with the DA's office (along with public interest groups) regarding abusive lending litigation. The FMTI noted, "these are not easy cases to handle. The issue is proof as the majority of cases are based on 'bait and switch' practices." The FMTI is working on developing a trust fund for loan pool money to pay for litigation and they will be training law students and local Legal Aid attorneys in predatory lending litigation under the auspices of the California Bar. They have forwarded a grant proposal for significant funding through the City of San Jose. This effort (absent a local ordinance) can assist in addressing the issue.

(c) What parts of predatory lending in San Jose are not currently legal?

Currently, all aspects of predatory lending in San Jose are outlawed in some way, shape or form by existing statutes. It will be difficult to simply outlaw abusive lending practices via a local ordinance that attempts to precisely eliminate only the predatory loans (which credible data has yet to suggest exists in greater proportions in the City of San Jose than other locales) without killing desirable subprime loans… often the only way working families can obtain home ownership or capture the equity in their existing homes. Legitimate subprime lending and equity financing provides the backbone to many of the housing opportunity programs in San Jose and Santa Clara County that assist our community members hardest hit by the affordability crisis. The key is to work together to stamp out abusive lending through a program to educate and support consumers by empowering them to make sound decisions, while using *already existing* resources to prosecute actual predators who are breaking and will continue to break existing state and federal laws.

California Law regarding Predatory Lending

Currently, State law (enacted by Assembly Bills 489 and 344 – Migden) prohibits loans of $250,000 or less secured by 1-4 unit owner-occupied real property that have an APR which exceeds the interest rate cap of 8% above U.S. Treasury securities having comparable periods of maturity to the note AND have points and fees that exceed 6% of total loan dollar amount.

Credit insurance financing is prohibited for loans as described above.

Prepayment penalties are not allowed beyond the first 36 months of the loans and cannot exceed 6 month's interest on the loan.

The lender "must reasonably believe" that the borrower can make scheduled payments with the criteria that the consumer's total monthly debt be less than 55% of their gross monthly income. "Flipping" of loans is already illegal and the bills prevent refinancing without "identifiable benefit" to the borrower.

Mandatory housing counseling is not required; however, the consumer is provided notice that they have the right to receive mortgage counseling three days before signing the loan documents. It is prohibited to base loans strictly on the borrower's home equity, therefore no equity refinance. The bills also provide for same language forms based on the language used to transact the loan.

The state law intentionally continues to allow for reverse mortgages and open lines of credit loans because of the necessity for such credit options for families when trying to purchase their own homes, for those trying to avoid losing their homes, and for those that want to expand or improve their homes. The Legislature understood the need for such credit options given the high housing costs in California. ACORN was instrumental in the introduction of both bills.

Federal Law regarding Predatory Lending (HOEPA)

The Home Ownership & Equity Protection Act (HOEPA) of 1994 prohibits “High Cost” Non-Purchase Closed-End Loans defined as loans with an APR (after October 2002) greater than 8% of the U.S. Treasury Bill rate for comparable securities for the first loan; and 10% above for second and junior loans. Penalties and fees are not allowed to exceed 8% of the total loan’s dollar amount and equal to $400 or more. Again, prepayment penalties are allowed under the following circumstances: during the first 5 years of the loan and; if the loan must not cause the consumer to pay more than 50% of their gross monthly income towards “gross monthly indebtedness payments.” HOEPA also prohibits balloon payments for short-term loans. For covered loans, the Act mandates a warning if the lender has a lien on the borrower’s home that the lender could foreclose and the borrower could lose the home if they default on the loan payment.

(d) What problems cannot be dealt with under the FNMA program that was launched in East Palo Alto, which even includes a fund to rescue victims of predatory funding?

The East Palo Alto example is another program template that can be emulated (and has been – see below). It operates without need for a local ordinance and provides for mortgage counseling, education programs, legal referrals and availability of rescue funds. The FannieMae program has broad enforcement capabilities. If anything, funding for addition legal help would be beneficial.

In Long Island, N.Y., the Long Island Housing Partnership and Freddie Mac last month launched "Don't Borrow Trouble," an anti-predatory lending campaign designed to help Nassau and Suffolk County, N.Y., residents spot and avoid unscrupulous lending practices and obtain practical financial and legal advice. As with East Palo Alto, this was done without the need for a local ordinance.

The Don't Borrow Trouble campaign has two primary goals: The first is to educate potential homeowners about predatory lending practices, such as excessive fees and hidden costs. The second goal is to help homeowners who've already been duped into high-cost loans by helping them refinance their loans. The people most susceptible to predatory lending practices are minorities, especially Latinos, who are buying their first home, and seniors, who often seek home improvement loans, according to the Long Island Housing Partnership.

A side benefit of the campaign is that people are calling to report mortgage brokers and bankers who've taken advantage of them. This "Don't Borrow Trouble" campaign combines outreach via churches, civic associations, and other community-based organizations with a consumer action network of attorneys, lenders, and 24 community agencies across Long Island. Freddie Mac has launched "Don't Borrow Trouble" campaigns in 32 communities during the past three years.

The Long Island Housing Partnership was the nation's first private, not-for-profit public-private affordable housing development organization based solely in the suburbs. It consists of 150 members from Long Island's business, educational, religious, labor, and educational sectors. Coincidentally, the Long Island Board of REALTORS® has a seat on LIHP's board of directors.

(e) What can we do that won’t kill Subprime lending?

Adoption of a local ordinance will severely curtail subprime lending. As a preventive measure, San Jose should consider implementing a comprehensive anti-predatory lending program that would include both proactive and reactive elements of enforced enhancement of the laws already in place, outreach and education. Funding assistance may be obtained from such sources as Freddie Mac's "Don't Borrow Trouble" program (as previously noted); HUD (which started the Consumer Fraud Hotline program in Los Angeles County); FNMA (see East Palo Alto). Research should be undertaken on other similar state and/or national funding assistance programs to augment current enforcement efforts and increase education and outreach to the citizens of San Jose.

For example, the proactive elements of the program could be modeled on the City of Sacramento's Home Loan Counseling Center: Financial Abuse Assistance Network (FAAN), which has a toll-free number (Santa Clara County's FAST program also has a toll free number) where citizens can call to ask questions about whether or not the loan(s) that they may be considering are predatory.

Legitimate subprime lending provides the backbone to many of the housing opportunity programs in San Jose and Santa Clara County. As noted, it is often times the <u>*only*</u> way working families can purchase a home or recapture their equity. A local ordinance (as had been witnessed in Oakland and the City of Los Angeles) will have the affect of severely curtailing those legitimate lending programs by regulatory requirement beyond state and federal laws. This will effectively preclude people who are unemployed in these recent economic times from accessing the equity in their homes at a time when it is most needed..

In 2002, Georgetown University did a comparison of the Oakland ordinance with AB 489 and HOEPA. They concluded: "The Oakland Ordinance and any similar legislation adopted in other jurisdictions will dramatically increase the number of mortgage loans subjected to stricter regulation. The Oakland Ordinance increases the number of both first and second mortgage loans considered to be "high-cost" loans so that approximately 90% of all loans in the database would be subject to more stringent regulation. We could not assess the impact of the Oakland Ordinance on the coverage of open-end loans. As a result, our results <u>***understate***</u> the impact of the Oakland Ordinance on mortgage lending."

All would agree that once a family has become involved in a predatory loan, the key is moving forward with litigation. A proactive program to educate working families will enhance the ability to catch the predatory activities before they have any irreversibly damaging results and could prevent the predatory loan from going forward in the first place, rather than waiting until the only option for resolution is court.***

(f) How are other states addressing the regulations issues of the banking business and the industry of loans, as it relates to the city level?

Georgia enacted a Fair Lending Act in October of 2002. Three months later, Standard & Poor's announced it no longer would rate mortgage-backed securities subject to the law because it included an assignee liability clause that permitted homeowners allegedly hurt by predatory lending practices to sue their lender or whoever purchased their loan, including holders of mortgage-backed securities. <u>San Jose's ordinance has an identical provision for "assignee liability."</u>

The Georgia law was modeled on regulation passed in North Carolina. The Georgia version provided that virtually everyone in the lending process - including bankers, brokers, and anyone buying the right to collect payments (such as FannieMae) - is liable if the loan violates this state law, which was introduced by ACORN. This law is one of the bases for the local ordinances seen in California.

A study by Keith D. Harvey from Boise State University, Boise, Idaho and Peter J. Nigro from the Office of the Comptroller of the Currency in Washington, D.C. examined the effect of the 1999 North Carolina predatory lending law on mortgage activity in that state as compared to other states in the Southeastern United States.

Using 1998-2000 HMDA data, they found that the North Carolina law reduced the overall level of subprime mortgage lending activity. Furthermore, the North Carolina decline was caused by a decline in loan application volume and not by a change in loan denial rates, suggesting less aggressive marketing in that state after the imposition of the law.

Finally, the impact of the legislation was different by both the type of financial service provider and borrower. Specifically, non-bank subprime lending contracted faster in North Carolina when compared to the control group, while both minority and LMI applicants were also less likely to get loans following the legislation. As they noted, these results have wide ranging policy implications given that several predatory lending proposals are currently before Congress, as well as proposed in other states (and cities).

In New Jersey, according to new research conducted by University of Virginia Professor Richard Demong, 40 percent of New Jersey's mortgage brokers and lenders have shuttered their offices or reduced their staff since the state's anti-predatory lending law took effect November of last year. The legislation has slashed access to subprime credit in the state, the study concludes, which in turn has led to a 67.2-percent plunge in cash-out refinancings and a 75.4-percent drop in originations of subprime home-improvement loans.

Cities are threatened by the same ratings downgrade inflicted upon Georgia as a result of their adopting such a law. Two major rating agencies have already announced they will not rate residential mortgage backed securities (RMBS) bonds that include mortgages coming from Oakland and Los Angeles, who are holding in abeyance the implementation of local anti-predatory lending ordinances. Both Oakland and Los Angeles have ordinances containing "assignee liability" provisions. In a nutshell, this means any company or individual who assumes a mortgage in the secondary market could be held liable if the loan's originator is in violation under the definitions of the ordinance even though the secondary purchaser has no way of knowing what occurred when the loan was negotiated (i.e., was it negotiated in a language other than English?)

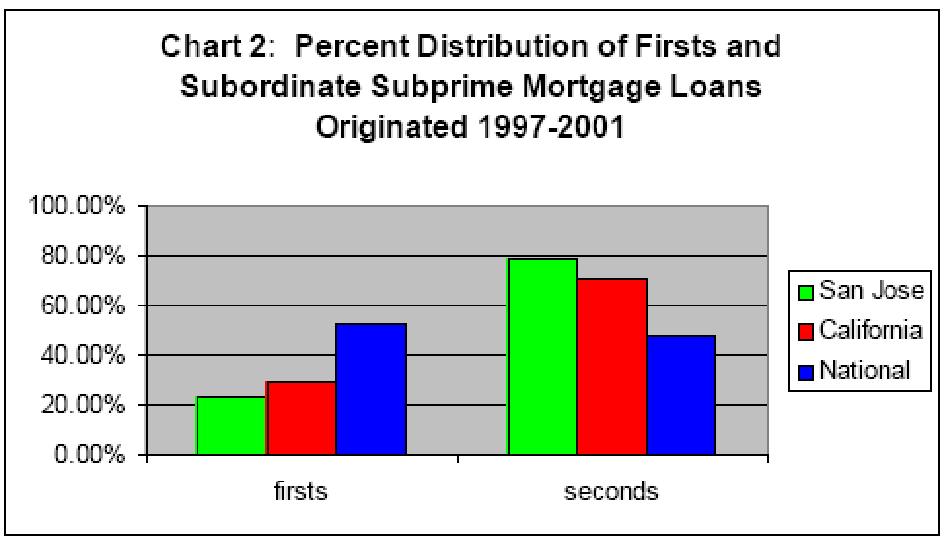
Both Fitch's Ratings and S&P have decided not to rate any municipal collateralized mortgage pool containing either City of Oakland or City of Los Angeles mortgages entered into after the date of enactment of their respective anti-predatory lending ordinances. Assuming Moody's, the final municipal bond rating agency, follows suit and refuses to rate residential mortgage backed securities (RMBS) structure financial transactions, funds containing these loans could be viewed as having “junk” status by the Wall Street investment banks. San Jose may be headed down this same path. This will, in turn, prompt an exodus of lenders from San Jose.

These problems also do not include the impact of reinvesting municipal funds for the City of San Jose. The proposed ordinance states that, “No moneys or funds held under any provision of the **Municipal Retirement System** or any other moneys or funds held by the City shall remain invested or hereinafter be invested in the stocks, securities or other obligations of any business which has been designated as a predatory lender…” Has the city’s Retirement Commission or the Civil Service Committee analyzed how this affects the pension of every city worker? It would seem prudent to do so to gauge the cost implications.

The city will have two years to divest its pension funds. <u>The ordinance also applies to contracts for goods or services, and to all the city’s banking relationships.</u> Interestingly, how such lending institutions are ‘designated’ is by the definitions contained in the proposed ordinance… the same parameters that could lower access to subprime credit in San Jose.

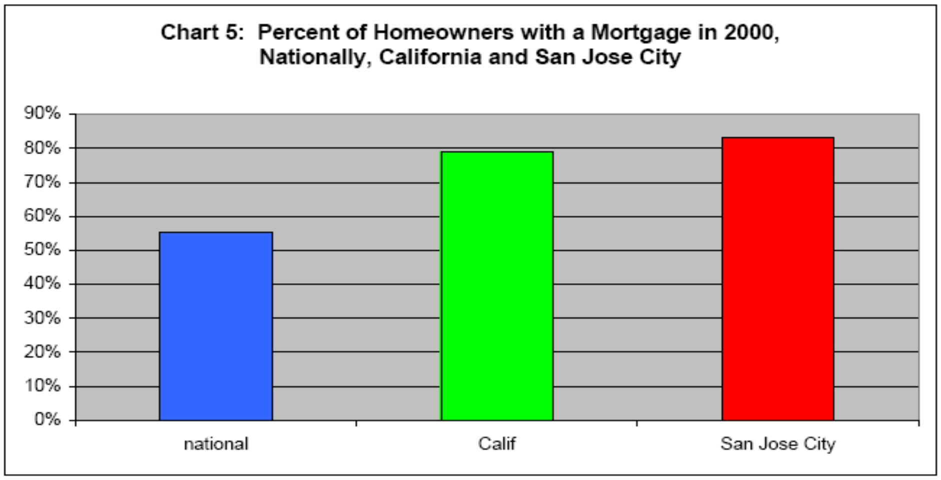
(g) Collect statistical data to point out if there is a real problem with predatory lending and if so, what is the severity of it?

The statistical evidence provided by AFSA and Real Estate Solutions clearly indicates that there is no substantial evidence of a dramatic increase in predatory lending practices in San Jose. While there may be an increase in subprime lending, San Jose’s lending market is adjusting to the unique market conditions caused by higher unemployment figures and housing costs. These two factors alone create a local lending market in San Jose that demands accessibility to subprime lending. Subprime lending is the necessary vehicle to getting people into homes and preserving their home ownership during economic downturns.

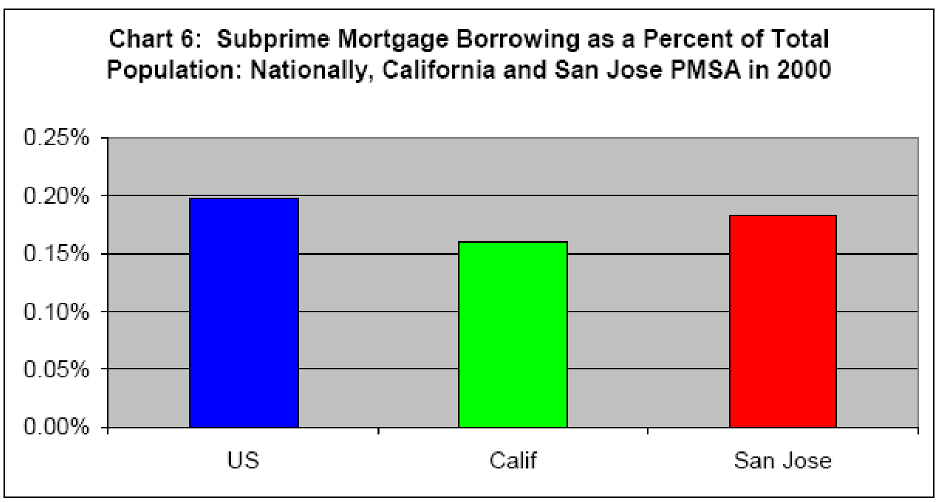


As evidenced by the previous chart, nearly 80% of subprime loans in San Jose are subordinate (i.e. seconds, thirds, etc.) subprime mortgage loans and not first or primary loans. Because of the high housing costs in San Jose, subprime loans are often the final critical piece needed to achieve the dream of homeownership for many families.

Often times, potential homebuyers will realize that their prime rate loan does not cover the entire purchase price of their dream home. After assuming the prime rate loan their loan-to-value ratio and/or debt ratio increases, they then discover that the only way they can afford their dream home is to take out a second or subordinate subprime loan to cover the rest of the costs, or given their credit history, a subprime loan is the *only* way they can refinance or purchase their home.

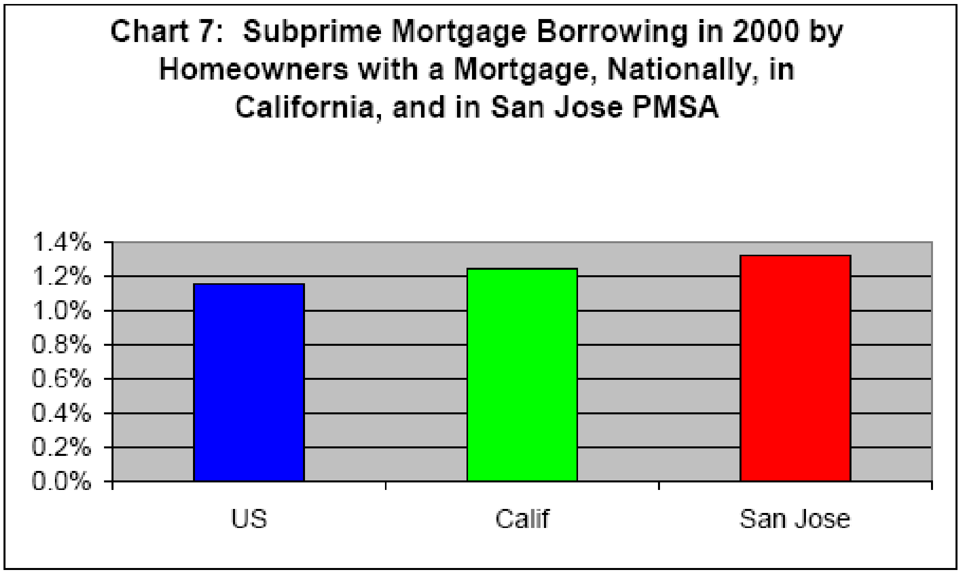


Looking at the above chart, we can see that there are many more homeowners with mortgages in California than nationally. In San Jose, the percentage of homeowners with mortgages is even higher. This further suggests that the high housing costs in San Jose produces the need for more mortgages; and in some cases, subprime loans in particular are needed to cover the elevated costs of purchasing a home in San Jose. This does not, by defacto or dejure definition, mean there is a dramatic increase in abusive lending practices in the City of San Jose.

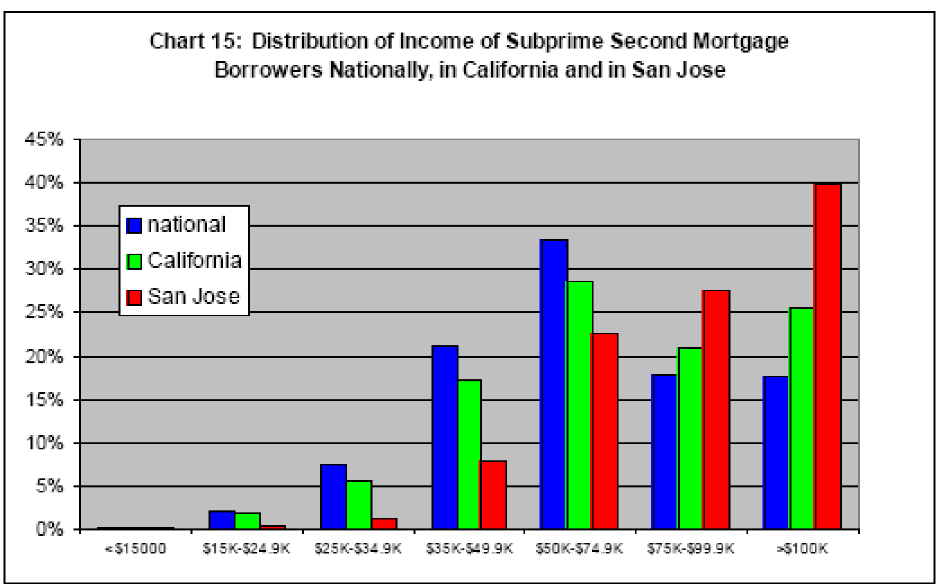


Contrary to the arguments that state that there is an unprecedented increase in predatory lending activities in San Jose, the chart above illustrates that subprime loans are utilized less often in San Jose than nationally. If there truly were an increase in predatory lending activities, a higher percentage of subprime lending should be reflected. However, the facts clearly show that this is not the case.

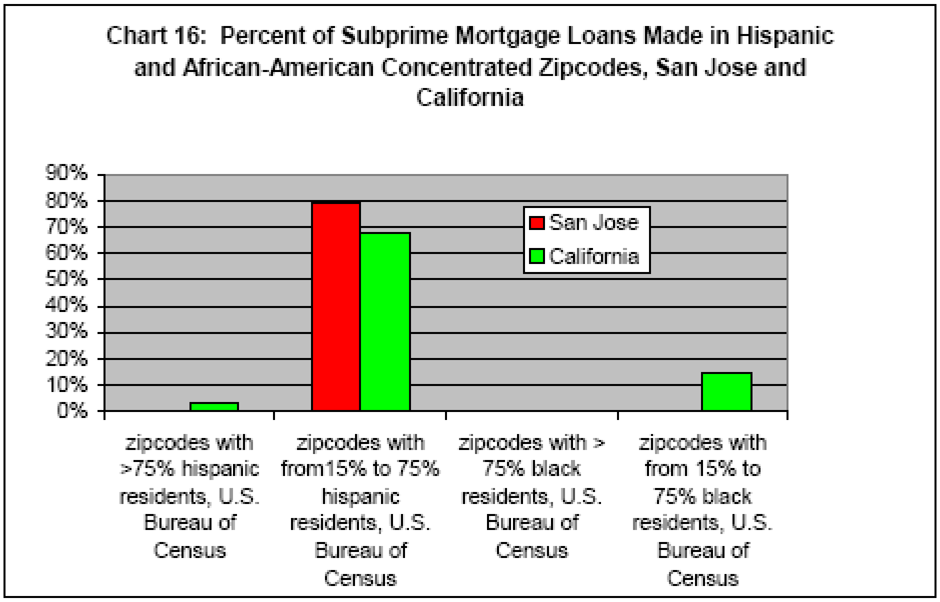
Today with the higher housing costs in San Jose and changing demographics, there is no longer a typically defined "household". Families in San Jose today may include adult children who still live with their parents, as well as grandparents, aunts, uncles and other extended family members. This trend is reflected in an even more affected fashion in some specific demographic groups.



This leads many families to have to make critical housing decisions, such as moving into larger homes or building additions. Many families caught in this trend of expanded family sizes already have mortgages. Therefore, when they borrow money to move into a larger home or build an addition to their homes, they only qualify for a subprime loan given their LTV (Loan to Value) and debt ratios. This is reflected in the graph above, which shows that in San Jose, more so than nationally and in California, subprime mortgage borrowers already have existing mortgages.



Lower income households may be the primary users of subprime lending, and the dramatized victims of predatory lending are often characterized as low-income. By contrast, in San Jose, the users of subprime lending are relatively wealthy (when compared to other SMSAs). Therefore, the presumption that low-income families are victims targeted for predatory loans in San Jose is vastly unfounded given the corresponding lower use of subprime loans by low-income families.



The Center for Responsible Lending (an offshoot of various public interest groups) as drawn the conclusion that since there has been a substantive increase in subprime lending (the subprime market has grown dramatically over the past few years-in 1998 subprime originations in the U.S. totaled $160 billion, more than a 500% increase since 1994)… there MUST be a correlated increase in predatory lending. That's akin to saying that because the number of churches has increased, there must be more people going to church.

The CRC goes on to state, "This growth has attracted new lenders and mortgage brokers to the market. For example, the number of mortgage brokers originating subprime mortgages in the U.S. today is over 18,000, triple the number five years ago. In addition, more conventional mortgage lenders have added subprime loans to their product menus, and many smaller, local home equity companies have been acquired by large firms with nationwide origination capability." This growth could also be viewed as opening an opportunity to credit damaged borrowers who did not have an opportunity to borrow in the past because subprime lending was less available.

The report, in addressing the question: Shouldn't a subprime lender be allowed to charge higher rates and fees to these borrowers because of the higher lending risk, states, "pricing on financial products should be based on the relative risk of loss that a lender takes in extending credit. This risk is determined by both the incidence of borrower default and whether there is collateral securing the loan... subprime loans do have higher losses than "A" quality mortgages or home equity lines of credit."

The proponents for an anti-predatory lending ordinance further argue that the "victims" of predatory lending practices are often minorities. However, in looking at the above chart, one can clearly see that an overwhelming 80% of subprime loans are used by borrowers in zip codes with a regular distribution of 15% to 75% Hispanic residents.

This statistical spread is too broad to prove there is a greater or lesser problem with abusive lending practices in the City of San Jose than in other locales. <u>More to the point, subprime borrowing in neighborhoods with greater than 75% Hispanic residents is negligible.</u> The data reveals there is no crisis of predatory lending in San Jose and therefore, calls into serious doubt the need for a local ordinance.

Many working families that use housing down payment assistance programs have been able to realize the dream of home ownership through the use of subprime loans. More than 3,5000 San Jose resident recently attended an Affordable Housing Fair (sponsored by the Santa Clara County Association of REALTORS®, the Mercury News, the California Association of Mortgage Brokers, and the Hispanic Association of REALTORS® and Affiliates). All were seeking ways to realize the dream of home ownership or to refinance their existing homes.

If a local ordinance (such as those in Oakland and Los Angeles) is adopted, there is concern this will remove a vital element in the home buying process for those with poor or bad credit records, insufficient credit history, non-traditional credit sources or unemployment (in the case of re-financings).

No one involved in this issue endorses predatory lending. Predatory lending is illegal and we stand side-by-side with groups such as ACORN, the San Jose Silicon Valley Chamber of Commerce, Working Partnerships, USA, the Tri-County Apartment Association, AARP, the California Association of Mortgage Brokers –Silicon Valley Chapter, the Fair Mortgage Terms Initiative, and the Public Interest Law Firm in that battle.